pricing. But the safeguards always turn out to use some measure of "cost" that no rational business, least of all our competitors, would ever use: for example, one "based strictly on differences in capacity" (CompTel, p. iii) or "uniform loadings of overhead" (WilTel, p. 31). Or they define as "discriminatory" market-based behavior that they engage in all the time. (See above, p. 36.)

The protectionist position has also lost its persuasiveness as we gain more experience with competition. The Commission has radically reduced or eliminated price regulation of cellular, billing and collection service, inside wire, CPE, and most of AT&T's long distance services, without any complaints from competitors of the incumbent provider. (The sole exception to this that we know of was MCI's objection to AT&T's Tariff 12 services, which was soundly rejected by the D.C. Circuit.[110]) There are cross-subsidies in our business, but they flow from competitive services to noncompetitive ones, which is not what our competitors pretend to be concerned about. A pro-competitive plan would redress these subsidies so that all competitors are on an equal footing.

Then there are the providers who've offered vertically and horizontally integrated service across numerous markets for years free of most of the constraints on us. We aren't referring to AT&T or MCI, but to at least 45 LECs, some of them larger than us (see Table 1, after Summary), who provide

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110 Competitive Telecommunications Assoc. v. FCC, 998 F.2d 1058 (D.C. Cir. 1993).

interLATA services. As one publication we subscribe to dryly commented,

> The argument Bell Companies will somehow discriminate has attained great currency. But it's a bit like that perennial bugaboo affecting welfare reform: that somehow there are these welfare recipients out there buying Delmonico steaks and driving around in new Cadillacs. No one's ever really seen it happen, of course, though we can all well imagine that it does all the time.
>
> Here, however, to the best of our knowledge, over the past decade, no long-distance company has been unable to provide toll service into or out of Connecticut, Cincinatti, Rochester, New York, Edinburg, Virginia, or any of the other hundreds of places that the local carrier is also competing in the long distance business. There's no evidence that dreaded leveraging local exchange "market power" has enabled SNETCO or, for that matter, United Telecom, to accomplish any of the familiar litany of anticompetitive things.... Of course, if there is, we've got a whole lot of divestiture yet to be forthcoming.[111]

In the report he prepared for GTE's Comments in this proceeding, Dr. Mark Shankerman also provided an intelligent and balanced discussion of the potential for anticompetitive behavior in local access markets. Dr. Shankerman's list of potential anticompetitive strategies is exhaustive. It includes preemptive investment, vertical price squeezes, predatory pricing, and cross-subsidization. Yet in each case he shows conclusively either that the potential strategy is

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[111] Telecommunications Policy Review, vol. 10, no. 14, April 3, 1994, pp. 1-2.

impracticable, or that asymmetric regulation is an impracticably expensive way to go about preventing it.

For example, our competitors would like the Commission to believe there is something about our business that makes it an exception to the Supreme Court's observation that "predatory pricing schemes are rarely tried, and even more rarely successful."[112] But the cost characteristics in nearly every one of our markets penalize anticompetitive behavior. This is implicitly conceded by some of our competitors. For example, WilTel says that the marginal or incremental cost of fiber-based services is trending toward zero. (WilTel, p. 13.) Obviously, if the incremental cost of expanding or reactivating a fiber-based network is close to zero, fiber-based services are uniquely unsuited to predation and WilTel's real concerns must lie elsewhere.[113]

Transport is not the only one place that we lose market power the moment another provider comes on line. The unit costs of switching have declined almost as dramatically as

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[112] Matsushita Electrical Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986).

[113] Consider a building or buildings served by two competing fiber-based providers, A and B. Because of the huge elasticity of the supply (the capacity of either provider alone is enough to serve the entire demand of the building or buildings) neither A nor B has market power. Even if A succeeded through illegitimate means (such as cross-subsidy from a different market where A does have market power) in driving B out of business, it would be a Pyrrhic victory for A, since the incremental cost of entry to yet another provider (c) of reactivating B's fiber would be minimal.

For the same reason TCG's advocacy of the Horizontal Merger Guidelines is irrelevant. They measure only market share, which every reputable economist would recognize as only one index of market power.

those of point-to-point transport media. Fifty years ago there was just one provider of dialtone in every exchange. Now, in many exchanges, there are hundreds of sources of dialtone -- CAPs, cellular providers, IXCs, end users who switch their own calls and connect private networks directly to high-volume transport providers. Of the seventeen dialtone-capable switches that IXCs have in the San Francisco Bay area, one model, the 5ESS, has a capacity of 120,000 lines scattered all over a metropolitan area, and will soon have the capability to approach 200,000 lines. Something similar is occurring in the local loop. The services provided today by all of the various wires and frequencies available to most customers can be provided more economically by upgrading them to broadband quality, even without considering the potential market for broadband services.[114]

We've said that today's technology punishes anticompetitive behavior. That includes anticompetitive pricing that is mandated by the Commission's and other regulators' rules. Where we are the sole provider of certain services, it's often because we're required to provide the service below our cost. This saddles us with social welfare costs that every provider ought to share, and encourages efficient providers from competing in those areas or for those services. Today's

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[114] See Application for Authority Pursuant to Section 214 of the Communications Act of 1934, and Section 63.01 of the Commission's Rules and Regulations to Construct and Maintain Advanced Telecommunications Facilities to Provide Video Dialtone Services to Selected Communities in San Diego, California area, File Nos. WPC-6913-16, Declaration of Robert G. Harris, February 26, 1993.

mandatory cross-subsidies work against us, not for us. And by protecting inefficient providers they work against consumers.

In his 1986 essay "Antitrust, Deregulation, and the Newly Liberated Marketplace," Judge Stephen Breyer examined the role the Commission had played in promoting protectionism in telecommunications regulation.[115] Though his specific subject was the long-distance business, much of the analysis now applies to us. Our interoffice transport markets, for example, are generally as open to competition as the long distance transport market was in 1986. In some of those markets, as we demonstrated in our Comments, we've lost more revenue share than AT&T had lost in 1986.

Breyer criticized the Commission for acting as a regulatory "handicapper" in three ways. First, through its access charge rules, the Commission ensured that AT&T paid more money for access than its competitors. The example Breyer gave was the premium rate that AT&T paid for Feature Group C access, but the equal charge per unit of traffic requirement would have been an equally good example. Second, the Commission "deliberately maintained a 'price umbrella' over AT&T's competitors. It refused to allow AT&T to cut its prices to the level of its incremental costs."[116] Third, the Commission imposed a set of administrative requirements on AT&T that did not apply to AT&T's competitors:

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115 Stephen Breyer, "Antitrust, Deregulation and the Newly Liberated Marketplace," 75 Cal. Law Review 1005 (1986).

116 Id. at 1023.

> When AT&T wishes to change its rates, it must file a proposed tariff. AT&T's competitors may then complain, the matter will be set for a hearing, and there is likely to be considerable delay before the rate takes effect. AT&T thus loses the benefit of its new tariff for several months, and its competitors gain the opportunity for anticipatory response.[117]

Two reasons were given for these handicaps. The first was the fear of predatory pricing. Breyer wasted no time debunking this.

> Does AT&T have a strong enough incentive to drive competitors from the market? To do so would likely invite either re-regulation or an antitrust suit under section 2 of the Sherman Act.... But, if AT&T did not drive its competitors from the field, how could it ever recoup what it lost by charging below-cost prices? When it raised its prices later in an effort to recoup, its competitors--still in the industry--would simply undersell it. In any event, why should regulators, rather than antitrust enforcers, decide whether predatory pricing exists? Of course, ... one might find cost complexities that argue for having regulators look for predatory pricing; but then one would face the countervailing risk that the regulators, by preventing [AT&T] from cutting prices to incremental costs, would destroy the whole point of allowing new competition, namely, creating a marketplace test for low-cost long distance service.[118]

The second reason Breyer called an "infant industry" argument: AT&T's competitors need to be "protected for a while, [so] they

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[117] Id. at 1024.

[118] Id. at 1025.

will eventually become strong enough to compete effectively."[119] While he judged this a "better" justification for handicapping than the fear of predatory pricing, Breyer still viewed it as fundamentally unsound:

> Given their growth and investment, do AT&T's competitors, really need protection? Protection may discourage these "infants" from developing the efficient practices needed to make them viable future competitors. Why can't they find investors who will sustain them in the short term, given the prospect of efficiency and profits in the long run? Finally, how long should we tolerate higher prices today in the hope of lower prices and better products tomorrow? Will our telecommunications infants ever grow up?
>
> It is also interesting to note that long-term handicapping is wasteful even if deregulation itself was wrongly conceived -- even if ... long distance service is a natural monopoly. In that case, forbidding AT&T from cutting its prices would deprive consumers of the benefits of lower costs. Such a prohibition would support inefficient ferry boats [competitors] in the presence of a bridge [natural monopoly] that could carry the traffic at lower social cost. Of course, if, as we have assumed, the long distance industry isn't a natural monopoly -- if it is structurally competitive -- then once AT&T's competitors become reasonably established, handicapping AT&T simply interferes with the competitive process. It discourages the very price cutting that deregulation seeks to bring about.[120]

The Commission's regulatory philosophy toward AT&T has progressed somewhat since Breyer made these observations in

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119 Id.

120 Id. at 1025-26.

1987. But read "the BOCs" for "AT&T" and the words still ring true. There are just two differences.

First, AT&T's competitors could argue with some justification that they faced a behemoth. Nobody can make a credible claim that our competitors deserve similar protection. They include non-infant AT&T, the most profitable of the Fortune 500, with 1993 revenues almost seven times ours;[121] MCI-BT, with combined revenues of $37B; or Sprint-France Telecom-Deutsche Bundespost Telekom, with combined assets of $155B and revenues of $70B.[122]

Second, price cap regulation itself, which Breyer did not consider because it had not yet been adopted, "substantially curtails the economic incentive to engage in cross-subsidization."[123] The modifications to price caps that we propose -- the elimination of the backstop mechanisms earnings caps, and other vestiges of ROR regulation such as more realistic depreciation lives -- would enhance, not detract from this characteristic of price caps.

The potential for competitive entry hovers over all of our markets, not just transport or switching. The courts have

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[121] Julie Pitta, "The 46th Annual Report on American Industry; Computers and Communications", Forbes, January 3, 1994, at 120. This preceded the divestiture of our cellular operations and AT&T's acquisition of McCaw, so the revenue disparity is now greater.

[122] "Sprint Deal Raises Specter of Trade Flap", Wall Street Journal, June 15, 1994, at B2.

[123] Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. at 2924; National Rural Telecom Ass'n v. FCC, 988 F.2d 178; U.S. v. Western Elec. Co., 993 F.2d at 1580.

recognized for many years that potential as well as actual competition deters anticompetitive conduct by dominant firms.[124] That's why the Department of Justice's merger guidelines call for the inclusion of potential entrants (within two years) along with actual, present competitors in the definition of a relevant market.[125] It's also the reason the Department has supported lifting the ban on our entry into the interLATA business, so long as either facilities-based or resale entry into the local exchange was possible,[126] "even if a residual core of local exchange service remains a natural monopoly."[127]

The price cap formula itself provides a ready index of market power. When we file rates, we must calculate the actual price index (API) on a basket level, and show that it doesn't exceed the price cap index (or PCI).[128] If we had market power our prices would be set at the legal maximum, the PCI. But they

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[124] See United States v. Penn-Olin Chemical Co., 378 U.S. 158, 174 (1964).

[125] U.S. Department of Justice, Merger Guidelines, April, 1992, reprinted at Trade Reg. Rept. (CCH), para. 13.100 et. seq.

[126] Thirty-nine states with over three-quarters of the U.S. population allowed intraLATA toll competition, as of October 1993. NARUC, Report on the Status of Competition in Intrastate Telecommunications (Nov. 1993), at 165-167. California will soon be among them. Our proposal to resell intraLATA loops and switch ports to competing providers (Pacific, p. 105) assures that any provider, even one without facilities of its own, will be able to piece together a network that competes with ours from end to end -- if not even farther (such as into the next LATA).

[127] U.S. v. Western Electric Co., No. 82-0192, (D.D.C.), Report and Recommendations of the United States Concerning the Line of Business Restrictions Imposed on the Bell Operating Companies by the Modification of Final Judgment, filed February 3, 1987, at 98.

[128] 47 CFR §§61.45, 61.46.

aren't.[129] The Commission recognized below-cap pricing as evidence of competition when it streamlined regulation of AT&T's Basket 2 and 3 services.[130] Although we propose a more conservative test for pricing flexibility, pricing below the PCI for any price cap basket is prima facie evidence of lost market power.

As Shankerman says, "all forms of asymmetric regulation contain an intrinsic bias toward some firms or technologies and therefore create the potential for very large efficiency losses."[131] Shankerman adds the following political dimension, which we submit is evidenced by the state of the long distance market.

> Once uneconomic entry is induced by asymmetric regulation, it creates political constituencies that make subsequent reform more difficult. This is especially true if the original investment costs were sunk. Furthermore, the technology used by entrants may induce large users and secondary suppliers to make complementary, sunk investments. Examples include the purchase of CPE equipment (especially PBX) to provide the LEC end office switching function, installation of fiber cable and terminals to link end user facilities and the interexchange carrier office, and human capital investments in the design, purchase and management of the customer's network. To the extent that these downstream, complementary investments are idiosyncratic (dedicated), they represent additional technical efficiency losses associated with

[129] See Pacific Bell, Transmittal No. 1701, amended June 14, 1994.

[130] Price Cap Performance Review for AT&T, 8 FCC Rcd. 6768, 6970 (1993).

[131] Shankerman May 9, 1994 Report, p. 3.

> the original uneconomic entry. Moreover, they extend the constituency interested in the maintenance of the status quo, and intensify the political pressure to preserve existing competitors rather than the competitive process.

Id., pp. 3-4. That asymmetric regulation creates protectionist constituencies who are themselves anticompetitive isn't a radical notion dreamed up by Stephen Breyer or Dr. Shankerman. It strikes a chord with anyone who has observed the effect of regulation on competitive markets. Price regulation of competitive markets creates and coddles inefficient providers; exacts a toll on consumer welfare; and reduces the Commission to the thankless and ungratifying task of hammering out "unprincipled compromises of Rube Goldberg complexity among contending interest groups viewed merely as clamoring suppliants who have somehow to be conciliated," as the Seventh Circuit observed of the Commission's attempt to regulate the broadcast market.[132] It puts the Commission between the devil and the deep blue sea. On the one hand are the "clamoring suppliants", who can hardly be put out of business (no matter how inefficient) without attracting notice from members of Congress on whom the Commission depends for its funding. On the other are the Supreme Court and the Courts of Appeal, which have made clear they won't tolerate the "unprincipled compromises" that result from trying to improve the workings of already competitive markets. Recently the Commission's record on appeal

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[132] Schurz Communications v. FCC, 982 F.2d 1043, 1050 (7th Cir. 1992).

of common carrier decisions has been dismal. In three months the courts have reversed three separate attempts by the Commission to handicap competitive markets.[133] It's noteworthy that one of the few recent common carrier decisions to survive appeal was the price cap order.[134] It was a progressive piece of work. But the work remains unfinished.

Breyer's concerns about the effect of protectionist policies on the long distance market were farsighted. Predatory pricing hasn't occurred. The long distance market is instead an oligopoly, dominated by AT&T and characterized by umbrella pricing. The "Big Three" carriers share almost nine-tenths of the switched market. They enjoy supracompetitive profits.[135] Despite the huge economies of scale that typify the long distance business, which argue against the efficiency of having hundreds of long distance carriers,[136] similar profits are enjoyed by a seemingly infinite number of infinitely smaller Tier 3 carriers. Indeed, the Commission itself has recently reported that in 1992 and 1993 price increases in household long distance rates were more than three times the rate of

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133 MCI Telecommunications Inc. v. AT&T, No. 93-358 (U.S. June 17, 1994); Bell Atlantic Tel. Co. v. FCC, No. 92-1619 (D.C. Cir. June 10, 1994); Southwestern Bell Tel. Co. v. FCC, No. 91-1416 (D.C. Cir. April 5, 1994).

134 See National Rural Telecom v. FCC, 988 F.2d 178 (D.C. Cir. 1993).

135 See Pacific, p. 38 and Table 1, above.

136 P. Huber, The Geodesic Network II, (1993) p. 1.21.

inflation.[137] Nonetheless, even the smallest Tier 3 long distance carriers have developed powerful allies in Congress who are determined to keep them in business.[138]

The Commission has better things to do than countenance this unbalanced state of affairs. The unprincipled rate reductions and ROR adjustments proposed by some parties in this proceeding would make it even worse.

VII. CONCLUSION.

The current rules discourage investment in our network and hurt consumers. Among other changes to the rules that we suggest above, earnings limitations should be eliminated. New service regulation should be streamlined. The productivity adjustment should be eliminated to reflect competition and the substantial depreciation reserve deficiency that we incurred to provide universal service; or at the very least, reduced to a

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[137] "Trends in Telephone Service", Federal Communications Commission, Industry Analysis Division, May 1994, at Table 5, p. 8.

[138] See for example Local Exchange Carrier Switched Local Transport Restructure Tariffs, CC Dkt. No. 91-213, Letter from Rep. Edward J. Markey, dated November 22, 1993.

level that reflects historical TFP growth. Pricing flexibility should be allowed for services in competitive areas.

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CERTIFICATE OF SERVICE

I, C. A. Peters, hereby certify that copies of the foregoing "REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL"re CC Dkt. 94-1, were served by hand or by first-class United States mail, postage prepaid, upon the parties appearing on the attached Service List this 29th day of June, 1994.

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